MEMORANDUM

To: Members of the Performance & Compensation Committee
California Public Employees' Retirement System

Date: June 13, 2011

From: Pension Consulting Alliance, Inc. (PCA)

cc:

RE: Alternative Investment Management (AIM) Staff Incentive Compensation Plan

As the AIM Consultant to the Investment Committee, PCA has been asked to comment on the proposed revisions to the Fiscal Year 2011-2012 Incentive Compensation Plans for the AIM Staff. PCA has reviewed the proposed matrix for the various positions within AIM.

The proposed revisions include a switch from a benchmark that was peer driven to one that AIM will be using for performance reporting effective July 1, 2011, (2/3 FTSE U.S. TMI + 1/3 FTSE All World ex-U.S. TMI) + 300 bps, one quarter lagged. As stated in PCA's May 19, 2010 memorandum when the peer-driven benchmark was adopted, PCA preferred the use of the Policy Index in the incentive compensation formula for AIM personnel. Another revision is the reduction for measurement purposes from a five-year to a three-year convention. The last revision relates to the strata used in the Incentive Schedule for computing incentive compensation.

PCA continues to believe that the use of the Policy index in the incentive compensation formula for AIM personnel is preferred. PCA also agrees with the adoption of the three-year convention because of its use throughout the incentive compensation program for investment office personnel. PCA further believes that the use of a public market index for AIM's incentive compensation program makes it more comparable to the programs used in the other asset classes. In setting the Incentive Schedule (0 bps = 0, +50 bps = 1, and +75 bps = 1.5), it was decided AIM's Schedule should be higher than that for the other asset class Staff, but not high enough to encourage excessive risk taking. Judgmentally, this Schedule was selected and PCA concurs with it.

It should be noted that, back-testing and reasonableness checks were complicated by: the issuance and adoption of Financial Accounting Standards #157 (now known as Topic 820, *Fair Value Measurements and Disclosures*) which required the use of market value in accounting for private market assets for fiscal years beginning after November 30, 2007; and, the high level of pricing volatility and short time-series experienced in the public stock markets since 2008. Consequently, PCA believes the factors used should be reviewed prospectively as more data becomes available.